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Steward Healthcare: A Cautionary Tale of Private Equity Remaking Non-Profit Hospitals Into For-Profit Entities

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On Monday, September 26, private equity firm Cerberus Capital Management announced that Medical Properties Trust Inc. (MPT) would buy all of Steward Health Care's hospital properties.[1] The real estate investment firm agreed to pay $1.2 billion for the properties and a further $50 million for a 5 percent equity stake in the health care system. Still struggling financially after six years of private equity ownership, Steward will lease back the properties for its hospitals and other facilities, paying rent to MPT. The deal will pay back Cerberus' initial investment in Steward and more, although the total amount the PE firm and its investors will receive has not been revealed. The deal will also pay down all of the company's more than $400 million debt and provide a payoff for top executives. Steward will receive an undisclosed amount to try once again to revive its failed strategy to acquire additional hospitals outside of Massachusetts and grow into a national powerhouse.

Cerberus has completed its effort to cut Steward in two: into an operating company that has been stripped of its most valuable asset and must run the health care system at a profit while paying rent on all of its real estate, and also a property company, MPT, to which Cerberus has sold all of the health care system's valuable real estate. The recent change in the status of the pension plan of Steward's workforce means Steward is also obligated to amortize the plan's very large unfunded

1 See Dayal McCluskey, Priyanka. 2016. "Steward Gets $1.25b to Fund Expansion, Repay Cerberus." Boston Globe, September 26. http://www.bostonglobe.com/business/2016/09/26/steward-gets-fund-expansion-repay-cerberus/hgC7sjOqZ1lnH1B1bV991M/story.html.

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liabilities over seven years — unfunded liabilities that grew instead of shrinking on Cerberus' watch. No doubt Cerberus would be happy to see Steward, which turned its first profit in 2015 after years of losses, succeed under these onerous conditions. A sale of Steward to another hospital chain or to the public via an IPO will mean a second payday for the PE firm and its limited partner investors. But whether the Steward health care system and the workers and communities that depend on it win or lose, Cerberus and its investors have already made their bundle.

How did a healthcare system that aspired to be transformative and serve as an example of how to improve the quality and experience of care while reducing costs end up like this — shorn of its most valuable asset and with high fixed costs that will be difficult to meet? It's a cautionary tale worth telling.

The story begins with one man's vision of how a struggling health care system could be turned around and could serve the needs of working class communities in Massachusetts by providing high-quality care at lower cost. In the third quarter of 2008, renowned cardiologist Ralph de la Torre left his prestigious position at Harvard University's Beth Israel Deaconess Medical Center to take over the leadership of the failing Caritas Christi Health Care System owned and operated by the Archdiocese of Boston. Not-for-profit Caritas Christi, the largest community-based health care system in New England, included six hospitals — two in Boston and four in nearby working class suburbs — plus a physician network, a college that trained nurses, and an international relief organization. It had about 13,000 employees — 10,000 in the six hospitals — and served more than half a million patients annually. A large share of the hospital workforce was represented by two unions — SEIU and the Massachusetts Nurses Association.

The situation facing Caritas Christi was grim when de la Torre was hired as CEO by the Archdiocese. The system was on track to lose $25.5 million, had $230 million in unfunded pension liabilities, had earnings that were close to zero, and faced skyrocketing deferred maintenance and capital needs. De la Torre believed he could turn around the struggling health care system by providing high-quality in-patient hospital care to the residents of Boston and the surrounding communities at much lower cost than the major Boston academic hospitals. De la Torre set out to revolutionize the delivery of in-patient care in the Boston area.

When de la Torre took over the Caritas system he had a vision about building high-quality, cost-effective, community-based care. In 2009, ahead of his time, he entered into a "shared risk" payments scheme with Blue Cross Blue Shield of Massachusetts. Caritas and Blue Cross would share the risks of caring for this population with the goal of improving the health of the insured population, and thereby reducing the costs of care. When Congress passed the Affordable Care Act (ACA), de le Torre was ready. Under the ACA, Medicare and Medicaid introduced shared risk payment schemes for hospitals and doctors intended to pay health care providers to keep people healthy. Accountable Care Organizations (or ACOs) are expected to reduce the cost of health care. De la Torre is quoted as saying, "We created the concept of the ACO on paper in '08. Our business plan is an ACO on steroids."[2]

De la Torre's vision and business model were predicated on increasing Caritas' share of the in-patient hospital market in Boston. To do this, he knew he would need to invest in upgrading the six hospitals in the network to make them more attractive and better able to serve the Boston area; he would need to acquire more hospitals so that fixed costs could be spread over a larger patient population; he would need to attract prestigious physicians' practices that could refer patients with less complex conditions to Caritas hospitals; and he would need to work with employers to provide their employees with health insurance that encouraged the use of Caritas hospitals. All of this would take money.

By late 2009, de la Torre had reached the limits of what he could do without additional capital and began looking for a buyer for Caritas, one with deep pockets. In 2010, de la Torre was able to interest Cerberus Capital Management's private equity group in his approach to shaking up and reforming the Boston hospital scene, and in November of that year Cerberus completed its acquisition of the hospital system. Acquired by the Steward Health Care System, a newly formed affiliate of Cerberus Capital Management, the six Caritas hospitals became the core of a hospital platform for Cerberus, which expected Steward to grow both organically and via acquisitions of additional community hospitals.

Turning not-for-profit hospitals into for-profit entities requires the approval of the attorney general of the state in which the hospitals are located. Cerberus' agreement with the Massachusetts Attorney General included assuming Caritas' debt and shoring up its underfunded pension plan. Cerberus also agreed that Steward would carry out $400 million in capital expenditures over four years to address deferred maintenance and to upgrade the hospitals' infrastructure. A serious flaw in the agreement, however, was that the $400 million did not all have to come from Steward's PE owners; it could also come from the health care system's own balance sheet through financial engineering that included having Steward monetize some of its assets and sell junk bonds secured by its real estate. The attorney general also attached two strings to the agreement: Steward could not close, sell, or transfer

2 See Leonard, Devin. 2016. "Private Equity Hospitals: A Business Model for the Obamacare Era." Bloomberg, August 29. http://www.bloomberg.com/news/articles/2013-08-29/private-equitys-hospitals-a-business-model-for-the-obamacare-era.

a majority ownership interest in any of the hospitals for five years (failing hospitals could be closed or sold in three years, and one was) and Steward could not take on additional debt to fund a dividend payment to its PE owners for three years.

According to PitchBook Data, Cerberus acquired the six hospitals and affiliated units of Caritas Christi on November 6, 2010 in a $420 million leveraged buyout plus assumed debt and pension liabilities of $475 million that valued the healthcare system at $895 million. The commitment to keep all six Caritas hospitals open and Steward's agreement to fund the hospital system's pension fund were very important to both SEIU and MNA, which supported it more or less enthusiastically despite the unions' misgivings about introducing private equity's focus on profit into a struggling community hospital system.

To increase the patient population seeking in-patient services at Steward Hospitals, de la Torre and Cerberus undertook several key initiatives.[3] Steward quickly added to its health care network by acquiring four more acute care community hospitals in 2011. And it kept its commitments to renovate and upgrade facilities, though much of this was financed by having Steward take on new debt. Steward acquired several large physicians' practices formerly affiliated with academic hospitals. It also developed a limited network health insurance plan for small businesses. By 2012, the Steward system was a $1.8 billion company with 17,000 employees (making it the third largest employer in Massachusetts) that cared for 1.2 million patients annually.[4] More than half its patients are elderly or poor, and on Medicare or Medicaid.

Initially, relations with the hospitals' workers and unions were good. The agreement that SEIU had negotiated with de la Torre prior to the buyout by Cerberus enabled the union to organize workers at all but two of the system's hospitals. SEIU added 4,200 members and went from 800 to more than 5,000 members through NLRB elections. But the relationship frayed as the difficulties community hospitals face in remaining financially viable came into conflict with the pressure to be profitable that accompanies for-profit ownership. Staffing issues in particular became acute as Steward Hospitals tried to meet their budget requirements by reducing regular staffing and meeting daily needs for nursing staff by utilizing a large number of per diem nurses. Neither union was happy, but MNA may have been more acutely affected than SEIU by the staffing changes. Certainly, its relationship with Steward had been tortuous.

3 Ibid.
4 See Mohl, Bruce. 2012. "Cerberus's Health Play." Commonwealth Magazine, July 10. http://commonwealthmagazine.org/health-care/001-cerberuss-health-care-play/.

De la Torre's vision for Steward at the time of the buyout is clear, but what did Cerberus hope to gain? Private equity firms are notorious for playing their cards very close to their vest, and Cerberus didn't disclose very much about its plans for making a profit on its acquisition of Steward. Nevertheless, there are clues to what the PE firm had in mind. It is axiomatic that at the time that a PE firm acquires a company for one of its fund's portfolios, it also considers its options for exiting the investment. According to de la Torre, Cerberus planned to use the health care system to develop and refine the Steward approach to making hospitals profitable and then expand it to other states.[5] It would then sell the expanded Steward system to another hospital system, or exit the investment by selling stock to the public via an IPO.

Unfortunately, the plan to make the Steward system a model for transformative change in the hospital industry did not go well. Convincing patients to seek hospital care in their local community rather than at the highly ranked academic hospitals — Massachusetts General, Brigham and Women's, and Beth Israel Deaconess — proved to be challenging. And reliance on a strategy of increasing in-patient services rather than investing in free-standing pre-acute facilities (e.g., urgent care centers, surgi-centers, and clinics) may have been short sighted. By mid-2014, three-and-a-half years after Cerberus bought the hospital system, Steward was still struggling to make its business model work and attract patients to its hospitals. And while Steward succeeded in building a network of hospitals in Massachusetts, it was not able to expand beyond the state's borders as de la Torre and Cerberus had hoped.[6] Efforts to do so either fizzled or failed to get off the ground. Meanwhile, Cerberus was stuck with the former Caritas hospitals for five years, and with some of the hospitals acquired later for ten.

What's a private equity firm to do?

Reports on the Steward Health Care System that were released by the Attorney General's office on December 30, 2015 begin to provide the answer.[7] The first report documents that, with the important exception of the sale of failing Quincy Medical Center, Cerberus fulfilled its obligations to operate each of Steward's hospitals, to invest $400 million (it actually invested $423 million) in upgrading the former Caritas hospitals' facilities and infrastructure, and to invest in the hospitals that were acquired later. However, in the second report — which examines, among other things, Steward's financial condition — we learn (p. 35) that "since initially investing $245.9 million in the

5 Ibid.

6 See Leonard, Devin. 2016. "Private Equity Hospitals: A Business Model for the Obamacare Era." Bloomberg, August 29. http://www.bloomberg.com/news/articles/2013-08-29/private-equitys-hospitals-a-business-model-for-the-obamacare-era.

7 Commonwealth of Massachusetts. 2015. "Reports on Steward Health Care System." Boston, MA: Commonwealth of Massachusetts. http://www.mass.gov/ago/docs/healthcare/shcs-report-123015.pdf.

system, Cerberus has not contributed additional equity to Steward." Most expenditures on infrastructure and facilities, it turns out, were financed by Steward by monetizing the health care system's assets to the extent possible and by having the health care system load up on debt. The Steward Health Care System owned a substantial amount of real estate, assessed at $599 million in 2012, according to property records that could be used for these purposes.[8]

In a familiar move for PE firms, Steward granted 99-year leases to a real estate investment trust (REIT) on 13 of its medical office buildings in April of 2012.[9] The REIT paid $100 million for the leases on these properties. It is unclear whether Steward or Cerberus received this payment, but typically in these situations the cash goes to the private equity owners, who in this case may have then used the funds to finance improvements it was obligated to make. The costs, however, fell on Steward, which then leased back those same buildings from the REIT for an undisclosed amount under a 12-year agreement. In 2013, the deal was restructured as a sale and lease back.[10] In August 2013, Steward granted hospitalist company, IPC Healthcare, exclusive hospitalist provider status for five years in exchange for a cash payment of $44.5 million. In 2014, Steward sold its testing and cytology laboratory services to Quest Diagnostics for approximately $35 million. That same year Steward agreed to a sale and lease back of one of its other hospital campuses including land, buildings, and equipment for $23.4 million. In short, Cerberus monetized whatever assets it could. It was, nevertheless, severely constrained in its ability to do this by its agreement with the Massachusetts Attorney General which stipulated that it could not sell the hospitals for at least five years. Cerberus, however, was free to use these assets as collateral for loans.

In 2011, its first year of operation, Steward established a revolving line of credit with three banks and borrowed close to $100 million; the maximum it could borrow was amended several times and increased to $275 million.[11] Then in 2013, a $285 million, seven-year term loan (i.e., Steward sold junk bonds) due in 2020 was set up to repay the outstanding balance of the revolving credit, which was amended to have a borrowing limit of $100 million.[12] Steward's hospitals and other real estate were collateral for the term loan and its other assets secured the revolving line of credit. As the Attorney General's report on Steward's financial situation noted (p. 36):

8 See Mohl, Bruce. 2012. "Cerberus's Health Play." Commonwealth Magazine, July 10. http://commonwealthmagazine.org/health-care/001-cerberuss-health-care-play/.

9 Ibid.

10 Commonwealth of Massachusetts. 2015. "Reports on Steward Health Care System." Boston, MA: Commonwealth of Massachusetts. http://www.mass.gov/ago/docs/healthcare/shcs-report-123015.pdf.

11 Ibid.

12 See Leonard, Devin. 2016. "Private Equity Hospitals: A Business Model for the Obamacare Era." Bloomberg, August 29. http://www.bloomberg.com/news/articles/2013-08-29/private-equitys-hospitals-a-business-model-for-the-obamacare-era.

"The solvency position of the system declined as debt increased, while operating losses and pension fund charges eroded equity. Outstanding debt (excluding pension liabilities) went from $326 million at the end of FY2011 to $413 million at the end of FY2014. By FY2014, equity was a negative $185 million, while total liabilities exceeded $1.4 billion." [13]

The combined Steward hospitals showed an operating profit of $14.4 million in FY2014 compared to a loss of $16.4 million a year earlier. However, as the Attorney General's report points out (p. 34), this turnaround in the hospitals' fortunes is largely the result of the redistribution of expenses from the hospitals to the parent company. The Steward Health Care System as a whole had a $75 million operating loss in 2014, marking four years of such losses.[14] It had its first operating profit in 2015 — more than $131 million.

Cerberus had also assumed responsibility for addressing the health care system's long-standing unfunded pension liabilities. However, no progress was made in putting the pension plans on a secure economic footing. In FY2014, pension plans that cover about 13,000 employees and retirees at Steward were underfunded by $368,615, up from its level a few years earlier (p. 37).[15] The pension plans at Steward have now transitioned into the private pension system, a plus for Steward's workers. Workers' pensions are now insured by the Pension Benefit Guaranty Corporation, which would provide retirement income to these workers should Steward enter bankruptcy. However, Steward is now required to amortize the neglected underfunded pension liability over a seven-year period, adding significant costs that Cerberus avoided to its struggle for financial survival.

Dividing a company — especially one like Steward that is struggling financially — into an operating company that must run the business and a property company that owns the real estate which is then sold to a real estate investment company or trust — can have disastrous effects. We don't know what will happen at Steward as its hospitals struggle under the burdens of rent that may be as high, or higher, than its previous loan payments and the obligation to make pension plan payments that include amortizing long-neglected underfunded liabilities. Perhaps Steward has received an adequate share of the payout from the sale of its real estate assets to Medical Properties Trust to rebuild its equity cushion. Perhaps it will be able to revive its failed plans for becoming a national powerhouse health care provider. What we do know is that the system's PE owners have seen a handsome return

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13 Commonwealth of Massachusetts. 2015. "Reports on Steward Health Care System." Boston, MA: Commonwealth of Massachusetts. http://www.mass.gov/ago/docs/healthcare/shcs-report-123015.pdf.

14 See Dayal McCluskey, Priyanka. 2016. "Steward Care Posts First-Ever Profits in 2015." Boston Globe, July 24. https://www.bostonglobe.com/business/2016/07/24/steward-health-care-stops-bleeding-money/JYKmRaPxdA4ZFhE9sM3fJI/story.html.

15 Commonwealth of Massachusetts. 2015. "Reports on Steward Health Care System." Boston, MA: Commonwealth of Massachusetts. http://www.mass.gov/ago/docs/healthcare/shcs-report-123015.pdf.

on their investment. We also know that it is not uncommon for companies stripped of their real estate assets — most often in retail or restaurants — to face bankruptcy once they were forced to pay rent in order to operate; some have even been liquidated. Future attorneys general considering letting investors privatize a non-profit healthcare system will need to be sure the agreement rules out asset stripping by the new owners. Whatever happens next, one thing is certain: the Steward Health Care System faces a difficult future.